

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 04-0335
Indiana Gross Retail Tax
For Tax Period 2000, 2002-2004

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ISSUES

I. Gross Retail Tax—Uncollectible Receivables Deduction

Authority: IC 6-2.5-6-9; I.R.C. § 166.

The Department and taxpayer interpret the requirements of IC 6-2.5-6-9 differently. The parties disagree as to when a taxpayer may “recognize” an uncollectible receivable.

II. Tax Administration: Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer operates automobile dealerships. That is, taxpayer sells used cars. Taxpayer also provides financing for its customers' used car purchases. As an Indiana registered retail merchant, taxpayer is required to file state gross retail tax (sales tax) returns and remit Indiana sales tax to the state on a monthly basis.

In determining the amount of sales tax to remit, taxpayer includes the used car's total purchase price in its reported “gross retail income [derived] from retail transactions.” From this base amount, taxpayer computes its sales tax liability.

Taxpayer's customers, from time-to-time, will default on their loan obligations. As a result, taxpayer may reacquire (i.e., repossess) the previously sold used car. Additionally, taxpayer may determine that the “delinquent” account receivable represents an “uncollectible receivable.” This “uncollectible receivable” may be used by taxpayer to reduce its Indiana sales tax liabilities. Specifically, taxpayer can deduct from its reported tax base (i.e., from “gross retail income [derived] from retail transactions”) the amount of the “uncollectible receivable.”

The parties' disagreement concerns their respective interpretations of IC 6-2.5-6-9. In particular, the parties disagree as to when an “uncollectible receivable” can be “recognized.” These

differences have resulted in additional assessments of Indiana sales tax. Taxpayer now protests these assessments.

DISCUSSION

I. Gross Retail Tax—Uncollectible Receivables Deduction

Taxpayer's complaint concerns the timing of the "uncollectible receivables" (or "bad debt") deduction. Specifically, taxpayer questions the Department's determination as to when a taxpayer may recognize (or take) a properly realized IC 6-2.5-6-9 "uncollectible receivable" deduction, prior to amendment effective January 1, 2004. Taxpayer reads the statute as requiring—or at least permitting—monthly deductions. Taxpayer explains:

[Taxpayer] takes this [uncollectible receivable] deduction on its monthly Indiana sales tax return for the month that the debt becomes uncollectible for federal income tax purposes. For example, if [taxpayer] writes off an uncollectible bad debt in the month of January for federal tax purposes, [taxpayer] takes the bad debt deduction on its Indiana sales return for January.

The Department, on the other hand, contends the Indiana sales tax "uncollectible receivable" deduction may be "recognized" only after a federal income tax return reporting the "uncollectible receivable" as a "bad debt" has been filed. That is, the Department views the federal income tax reporting requirement of IC 6-2.5-6-9 as a condition precedent; taxpayer, on the other hand, regards the federal reporting requirement as a condition subsequent.

IC 6-2.5-6-9, prior to amendment, provides (emphasis added):

(a) In determining the amount of state gross retail and use taxes which he must remit under section 7 of this chapter, a retail merchant **shall deduct from his gross retail income from retail transactions made during a particular reporting period**, an amount equal to his receivables which:

(1) resulted from retail transactions in which the retail merchant did not collect the state gross retail or use tax from the purchaser;

(2) resulted from retail transactions on which the retail merchant has previously paid the state gross retail or use tax liability to the department; and

(3) **were written off as an uncollectible debt for federal tax purposes during the particular reporting period.**

(b) If a retail merchant deducts a receivable under subsection (a) and subsequently collects that receivable, then the retail merchant shall include the amount collected as part of his gross retail income from retail transactions for the particular reporting period in which he makes the collection.

Resolution of this issue depends on the meaning of IC 6-2.5-6-9(a)(3)—i.e., the phrase “were written off as an uncollectible debt for federal tax purposes during the particular reporting period.” The parties agree the term “written off” refers both to an accounting determination and to a federal income tax reporting requirement. The parties agree that substantively an IC 6-2.5-6-9 “uncollectible receivable” must qualify as an IRC § 166 “bad debt.” The parties also agree that procedurally an amount deducted as IC 6-2.5-6-9 “uncollectible receivable” must be deducted on taxpayer’s federal tax return as an IRC § 166 bad debt. But the question remains as to whether this latter requirement must *precede* the “recognition” of the IC 6-2.5-6-9 deduction?

The Indiana “uncollectible receivable” deduction is limited, by statute, to those receivables which were “written off as an uncollectible debt for federal tax purposes during the particular reporting period.” IC 6-2.5-6-9(a)(3). The Department has interpreted this language as establishing both a substantive and a procedural requirement. The amount of the “uncollectible receivable” to be deducted pursuant to IC 6-2.5-6-9, substantively, must represent an IRC § 166 “bad debt.” And procedurally, the amount to be deducted must be reported on taxpayer’s federal income tax return as “bad debt.” Each requirement represents a condition precedent.

The statutory language is explicit. The language specifies that entitlement to the Indiana IC 6-2.5-6-9 “uncollectible receivable” deduction is conditioned on meeting the federal “bad debt” requirements of IRC § 166. The legislature adopted a regime to ensure that only those amounts representing IRC § 166 bad debt could be deducted from taxpayer’s “gross retail income from retail transactions” for Indiana sales tax purposes. IC 6-2.5-6-9(a)(3). For periods prior to January 1, 2004, a recognition that an amount meets the requirements of IRC § 166 occurs only when taxpayer claims a “bad debt” deduction on its federal tax return. Hence, the presence of a bad debt deduction on taxpayer’s federal income tax return must be viewed as a condition precedent.

For periods on or after January 1, 2004, IC 6-2.5-6-9(d)(3) permits write-offs of bad debts on a monthly basis, subject to a taxpayer’s substantiation that the debts became uncollectible and eligibility for a federal bad debt deduction for income tax purposes. Accordingly, taxpayer is sustained for those periods on or after January 1, 2004 subject to verification that the amounts were actually written off its books during that month.

The Department, however, has yet to determine whether the income at issue represented “qualified increased enterprise zone gross income.” Once Audit verifies the amount of “qualified increased enterprise zone gross income” to which taxpayer is entitled, this amount, pursuant to IC 6-2.1-3-32, will be excluded from taxpayer’s Indiana gross income.

FINDING

Taxpayer’s protest is denied/sustained for periods prior to January 1, 2004. Taxpayer’s protest is sustained for periods on or after January 1, 2004, subject to verification.

II. Tax Administration: Negligence Penalty

The Department may impose a ten percent (10%) negligence penalty. IC 6-8.1-10-2.1 and 45 IAC 15-11-2. Taxpayer's failure to timely file income tax returns, generally, will result in penalty assessment. IC 6-8.1-10-2.1(a)(1). The Department, however, may waive this penalty if the taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...." *Id.* Taxpayer, in this instance, has made such a showing.

FINDING

Taxpayer's protest is sustained.

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